DEPARTMENT OF FINANCE BILL ANALYSIS

AMENDMENT DATE: February 18, 2011
POSITION: Neutral

BILL NUMBER: AB 36
AUTHOR: H. Perea
RELATED BILLS: Ch. 660/10 (SB 1088)

BILL SUMMARY: Conformity: Under 27 - exclusion for health benefits

This bill would conform to the federal law that allows an exclusion or deduction from income for certain medical care expenses of a child under 27.

FISCAL SUMMARY

The Franchise Tax Board (FTB) estimates that this bill would result in revenue losses of $4.8 million in 2010-11, $38 million in 2011-12, $35 million in 2012-13, $40 million in 2013-14, and $44 million in 2014-15.

This bill is not expected to significantly impact the FTB's costs.

COMMENTS

Close conformity with federal law has the benefit of reducing complexity in tax preparation and administration.

Although the FTB is estimating a loss to the General Fund should this provision be passed, the revenue loss associated with conformity is based on taxation of a health care benefit that California did not tax in the past. The state conformed to the federal expansion of health coverage for qualifying children under 27, but failed to address the tax implications of conformity. Essentially, by not conforming, California would be imposing a new tax on employees taking advantage of federal health care changes. Since the revenue gain from not conforming was not built into the Governor's Budget forecast, the estimated fiscal impact is foregone revenue versus a revenue loss to the forecast.

From a policy perspective, avoiding conformity could cause a great deal of confusion for California employers and employees and thus, it Finance's opinion that the bill's benefits outweigh the foregone revenue of not conforming.

Analyst/Principal	Date	Program Budget Manager	Date
(0723) C. Angaretis		Mark Hill	

Department Deputy Director — Date

Governor's Office: By: Date: Position Approved_______
Position Disapproved

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ANALYSIS

A. Programmatic Analysis

Background:

The federal provisions of the Patient Protection and Affordable Care Act of 2010 and Health Care and Education Reconciliation Act of 2010 (enacted in March of 2010) were implemented to effect fundamental reforms to the United States health care system. Many of the provisions of the health-care acts do not take effect until 2014; however, one provision that became effective in 2010 requires group health plans and health insurance issuers that offer group or individual health insurance coverage, and that provide dependent coverage of children, to continue to make such coverage available for an adult child (who is not married) until the child turns 26 years of age.

To meet this requirement, a provision was enacted to add a new category of excludable or deductible medical care expenses for a child who has not attained age 27 as of the end of the taxable year. The new category applies to 1) reimbursements for medical care expenses under excludable employer-provided health coverage, 2) deductible self-employed medical insurance costs, 3) Voluntary Employees' Beneficiary Associations (VEBA) benefits, and 4) qualified retiree health plan benefits.

Current state law, as expanded by Chapter 660, Statutes of 2010 (SB 1088), conformed to federal changes in health care law by allowing an employee to provide health care coverage for a child up to the age of 26. This statue did not address the issue of how the benefit would be treated for tax purposes.

Current state law, for purposes of excludable employer-provided health coverage, deductible self-employed medical insurance costs, and VEBAs, conforms to the federal exclusion and deduction for dependent's medical care expenses that were in effect on January 1, 2009; thus, California does not conform to the new category of excludable or deductible medical care expenses for children under 27.

Current state law, for purposes of a qualified retiree health plan, automatically conforms to the new category that allows retiree's children, who have not attained age 27 as of the end of the calendar year, to be included in the plan.

This bill would conform to the new federal category of excludable or deductible medical care expenses for a child who has not attained age 27 as of the end of the taxable year. The new category would apply to 1) reimbursements for medical care expenses under an employer-provided accident or health plan, 2) deductible medical care insurance expenses of self-employed individuals, and 3) benefits provided under a VEBA, and would apply as of the same date the new category applies for federal purpose, to expenses incurred, and benefits provided, on or after March 30, 2010. Note: the provision related to qualified retiree health care benefits automatically conforms to the federal change by reference to the Internal Revenue Code (IRC).

This bill would be effective immediately as a tax levy and is specifically operative for expenses incurred and benefits provided on or after March 30, 2010.

This bill would also clarify that health premiums which would be excluded from reportable income for withholding purposes would also be excluded for Unemployment Insurance and Disability Insurance employer contribution purposes.

Detail of Provisions:

1) Definition of Dependent for Exclusion for Employer-Provided Health Coverage

Under current federal law the IRC generally provides that employees are not taxed on (that is, may "exclude" from gross income) the value of employer-provided health coverage under an accident or health plan. This exclusion applies to coverage for personal injuries or sickness for employees (including retirees), their spouses and their dependents. In addition, any reimbursements under an accident or health plan for medical care expenses for employees (including retirees), their spouses, his or her dependents, and any child of the taxpayer who, as of the end of the taxable year, has not attained age 27 generally are excluded from gross income.

Employers may agree to reimburse medical expenses of their employees (and their spouses and dependents), not covered by a health insurance plan, through flexible spending arrangements that allow reimbursement not in excess of a specified dollar amount (either elected by an employee under a cafeteria plan or otherwise specified by the employer). Reimbursements under these arrangements are also excludable from gross income as employer-provided health coverage. The same definition of dependents applies for purposes of flexible spending arrangements.

Current state law conforms to the federal definition of dependent for purposes of the exclusion for employer-provided health coverage as of the "specified date" of January 1, 2009. Thus, California does not conform to the federal change that extends the exclusion to any child of an employee who has not attained age 27 as of the end of the taxable year because it was enacted after January1, 2009.

Under current state law, any reimbursements under an accident or health plan for medical care expenses for employees (including retirees), their spouses, and their dependents are generally excluded from gross income. A dependent means a qualifying child or a qualifying relative. A child generally qualifies if they satisfy each of five specified tests for the taxable year, including a requirement that they be under the age of 19, or a full-time student under the age of 24, by the close of the tax year.

2) ***Deduction for Health Insurance Premiums of Self-Employed Individuals***

Under current federal law self-employed individuals may deduct the cost of health insurance for themselves, their spouses and dependents, and any child of the taxpayer who as of the end of the taxable year has not attained age 27. The deduction applies only to the cost of insurance (i.e., it does not apply to out-of-pocket expenses that are not reimbursed by insurance). The deduction does not apply for self-employment tax purposes. For purposes of the deduction, a more than two percent shareholder-employee of an S corporation is treated the same as a self-employed individual. Thus, the exclusion for employer-provided health care coverage does not apply to such individuals, but they are entitled to the deduction for health insurance costs as if they were self-employed.

Current state law conforms to the federal deduction for health insurance costs of self-employed individuals that was in effect on the "specified date" of January 1, 2009. Thus, California does not conform to the self-employment medical care insurance deduction for any child who has not attained the age of 27 by the end of the taxable year because it was enacted after January 1, 2009. Instead, self-employed individuals may deduct health insurance costs of themselves, their spouse, and their dependents.

3) ***Voluntary Employee's Beneficiary Associations (VEBAs)***

Under current federal law, a VEBA is a tax-exempt entity that is a part of a plan for providing life, sick or accident benefits to its members or their dependents or designated beneficiaries. For this purpose, the term "dependents" specifically includes any member's child who has not attained age 27 as of the end of the calendar year.

Current state law, for taxable years beginning on or after January 1, 2010, provides that an organization operating as a nonprofit VEBA as of January 1, 2009, may apply for tax-exempt status. Similar to federal law, California VEBAs may provide for the payment of health benefits to its members, their spouse, and their dependents; however, under California law, the term "dependents" means dependents as defined in the IRC as of the "specified date" of January 1, 2009. Therefore, California does not conform to the federal change to the definition of VEBA dependents to include any child of a member who has not attainted the age of 27 by the end of the calendar year.

4) ***Qualified Plans Providing Retiree Health Benefits (automatically conforms to the federal law change by reference to the IRC)***

Under current federal law, a qualified pension or annuity plan can establish and maintain a separate account to provide for the payment of sickness, accident, hospitalization, and medical expenses for retired employees, their spouses, and their dependents ("401(h) account"). For this purpose, the term "dependents" specifically includes any retired employee's child who has not attained age 27 as of the end of the calendar year.

Current state law conforms by reference to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC (IRC sections 401 through 420), relating to pension, profit-sharing, and stock-bonus plans, etc., without regard to taxable year. Thus, California automatically conforms to the federal change that allows plans providing retiree health benefits to retired employees, their spouses, and their dependents, to include within the meaning of "dependent" any child of a retired employee who has not attained age 27 as of the end of the calendar year.

DISCUSSION:

The FTB reviewed tax law in Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York because of their similarity to California's economy business entity types, and tax laws. The FTB found that Illinois, Michigan, and New York automatically conform each taxable year to the IRC, and thus automatically adopted the new category of excludable or deductible medical care expenses for a child under 27.

Minnesota, Massachusetts, and Florida conform to the IRC as of a specified date, similar to California. Neither Minnesota nor Massachusetts conforms to the new category of excludable or deductible medical care expenses for a child under 27. Florida does not impose a personal income tax; therefore, they are not applicable.

B. Fiscal Analysis

The FTB estimates that this bill would result in revenue losses of $4.8 million in 2010-11, $38 million in 2011-12, $35 million in 2012-13, $40 million in 2013-14, and $44 million in 2014-15.

This bill is not expected to significantly impact the FTB's costs.

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Code/Department Agency or Revenue Type	SO LA CO RV	PROP 98	FC	(Fiscal Impact by Fiscal Year) (Dollars in Thousands) 2010-2011	FC	2011-2012	FC	2012-2013	Fund Code
1147/Pers Inc Tax	RV	No	U	-$4,800	U	-$38,000	U	-$35,000	0001
1730/FTB	SO	No		------------------- No/Minor Fiscal Impact -------------------					0001